

Seattle City Light Financial Strategy

Carol K. Everson
Presentation to
Advisory Board
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Financial Strategy

- A set of financial policies and actions designed to achieve target financial conditions.

Financial Goals

- Lower Costs
 - but also worker safety, system and generator reliability, and community objectives
- Lower and Stable Rates
 - but sufficient to cover operating expenses, debt service, and some portion of capital costs
 - but send price signal about societal cost of electricity production
- Lower Debt
 - to reduce fixed costs and provide flexibility
 - but those who benefit pay cost of investment

Trade-Offs

- Dealing with an interdependent system
- Goals are not consistent
 - More or one may cause less of another
 - e.g. lower rates may mean higher debt
 - Consistent goals would be simple.
- Trade-offs among objectives are required
- Elected officials, Advisory Board, Rate Advisory Committee, etc. help make these trade-offs

Low Costs

- All financial strategies begin with achieving minimum costs, subject to:
 - maintaining capital assets
 - achieving community objectives
 - low income rates
 - environmental stewardship
 - conservation
- Operating efficiently allows both rates and borrowing to be lower

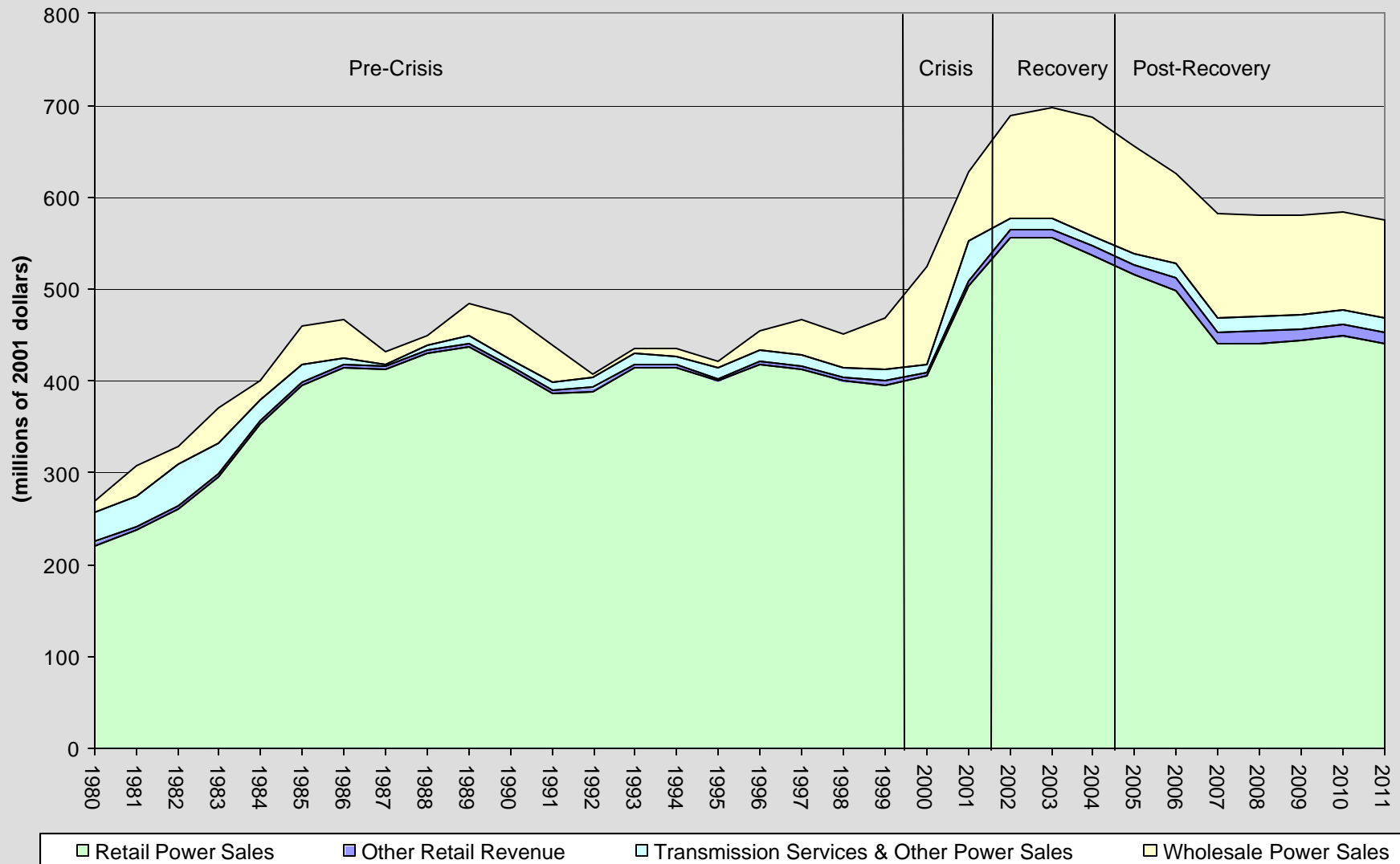
Cost Minimization Strategy

- Articulated most clearly as we prepare for biennial budget
 - strategies for 1997-1998 and 1999-2000 biennial budgets spelled out in memos
 - 2001-2002 and 2003-2004 budgets reflect energy crisis,
- Look at historical trends
- Benchmark vs other utilities

Information on Historical and Projected Revenues & Expenditures

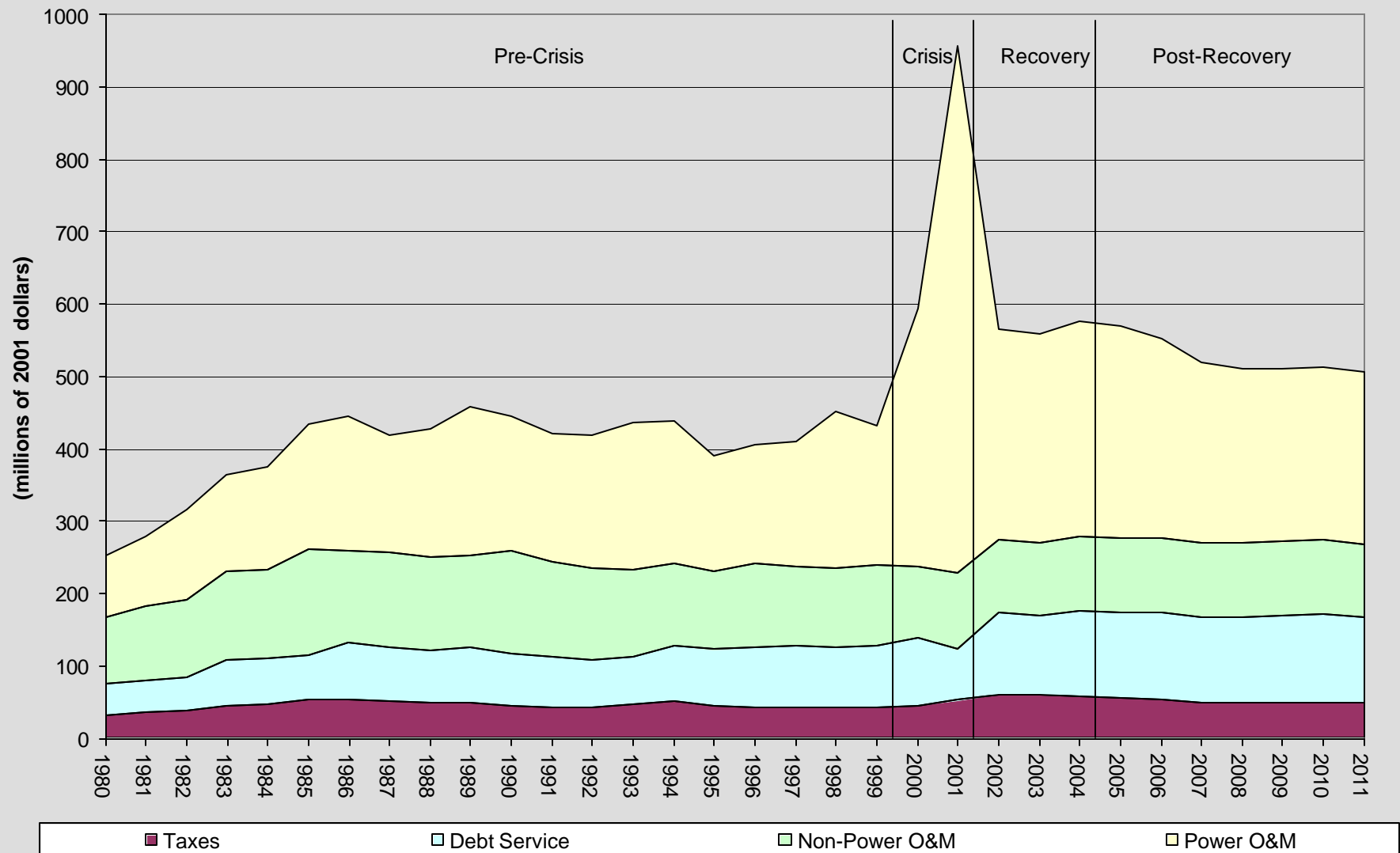
- Purpose is to give you a feel for relative magnitudes of revenues and costs
- Will go through quickly just pointing out major changes and trends
- Forecast from 2002 RAN OS forecast (completed October 2002)
- all figures are in millions of constant (or inflation adjusted) dollars

Revenue



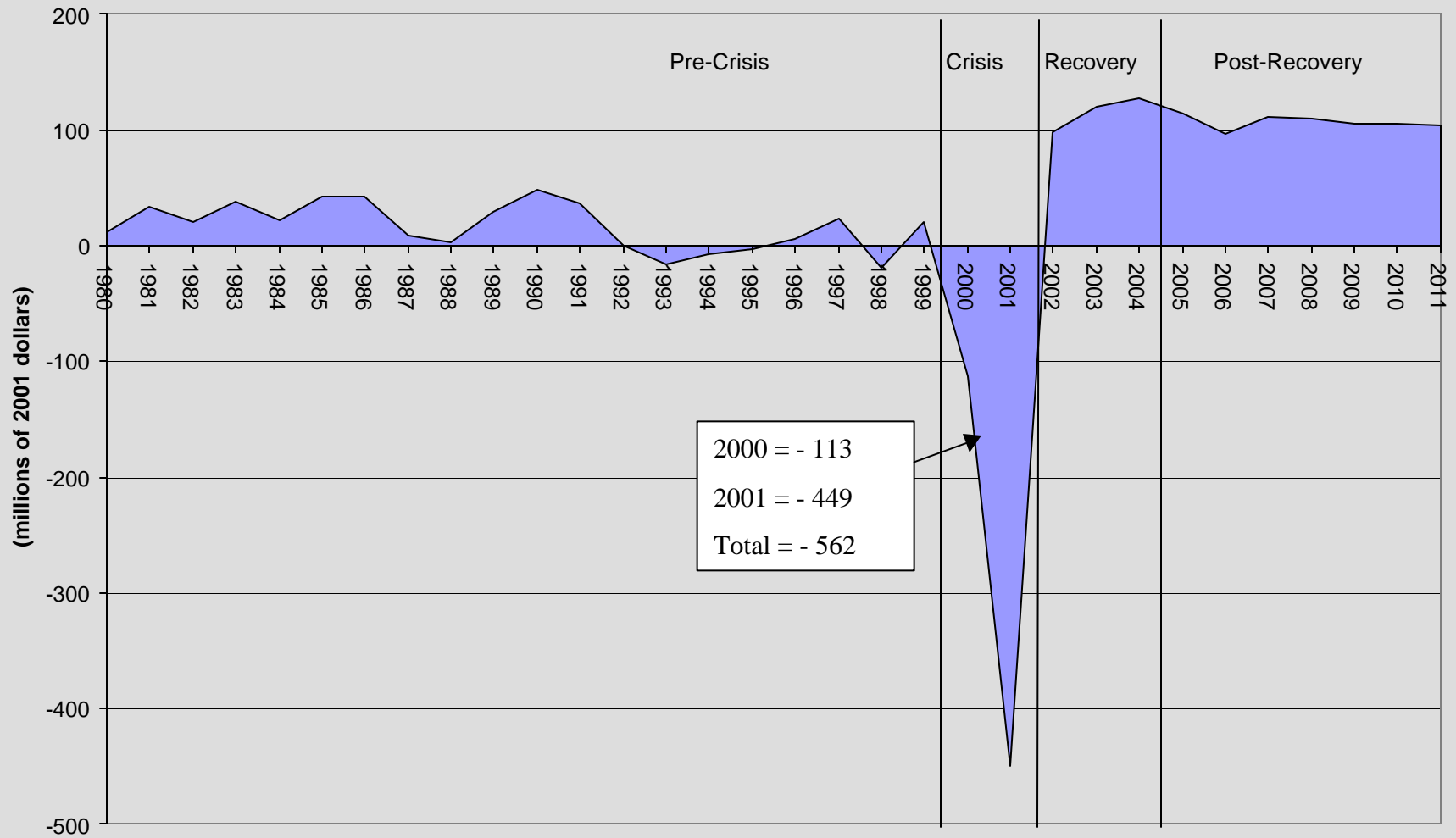
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Current Expenditures

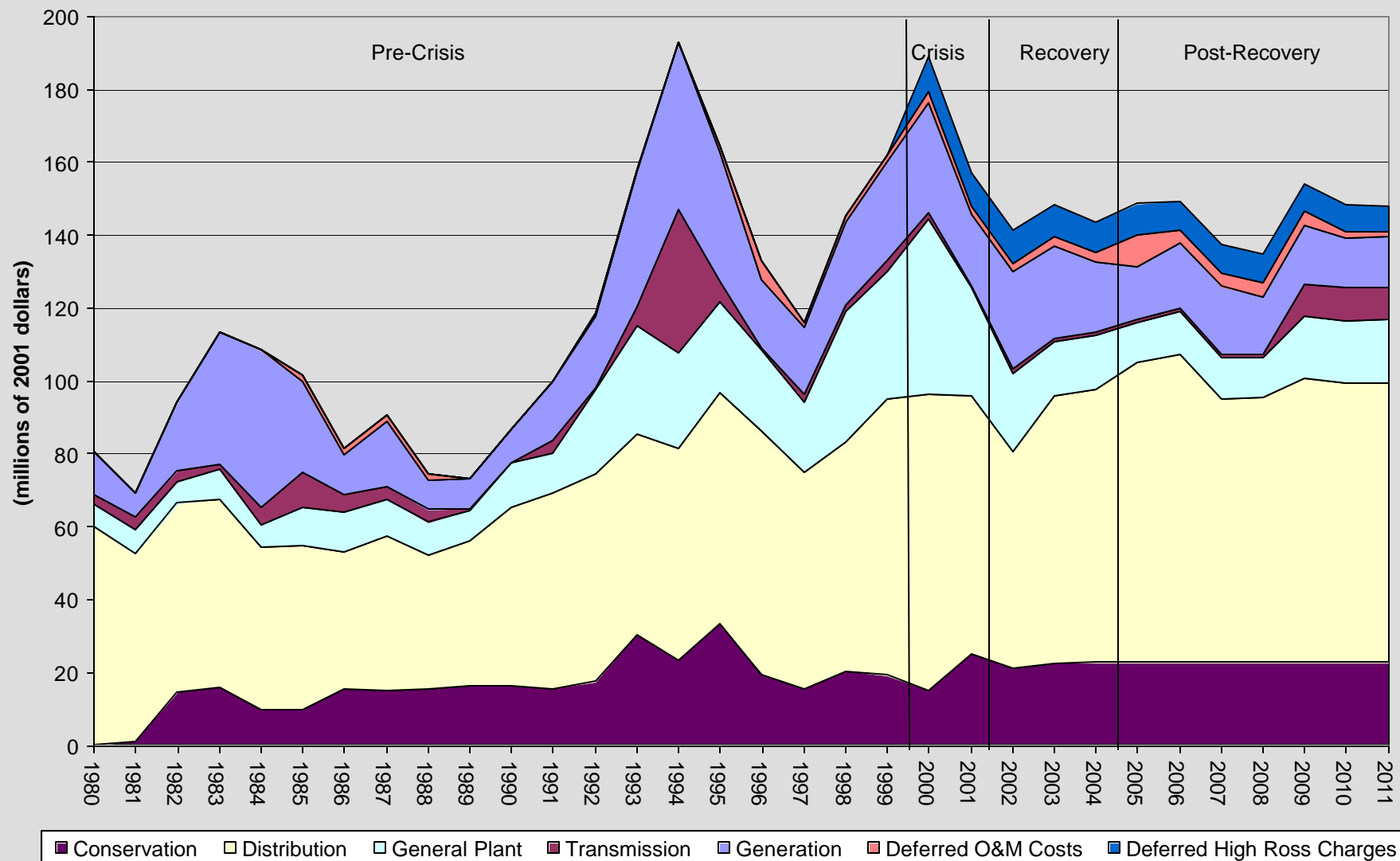


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Wholesale Power Sales net of Purchases



Capital Expenditures



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Changes in Capitalization Policy

- 1991 - Allocation of administrative & general (A&G) costs to capital projects
- 1993 - Capitalization of development costs of major data processing (DP) programs
- 1999 - Purchase non-specialized vehicles (as opposed to lease from City Fleets & Facilities)
- 2000 - defer a portion of High Ross purchased power payment

Capitalization and Debt Financing

- Capitalization is primarily an accounting policy.
- Whether to debt finance capital is a financial policy.
- With standard rate setting methodologies, if you capitalize more your debt level increases.



Financial Policies and Actions

- Given a level of O&M and Capital expenditure
- Given an assessment of variability of financial results
- Determine the level and structure of rates
- Determine the level and structure of debt

Financial Policies

- Used to determine revenue requirements
- Three things to specify
 - measure (debt service coverage, net income)
 - target (2.0, positive)
 - probability of meeting target (50%, 80%)
- Set by City Council resolution since 1977
- Process includes substantial input from financial experts including rating agencies
- Major changes in 1989 and 2001

Policies Prior to 1989

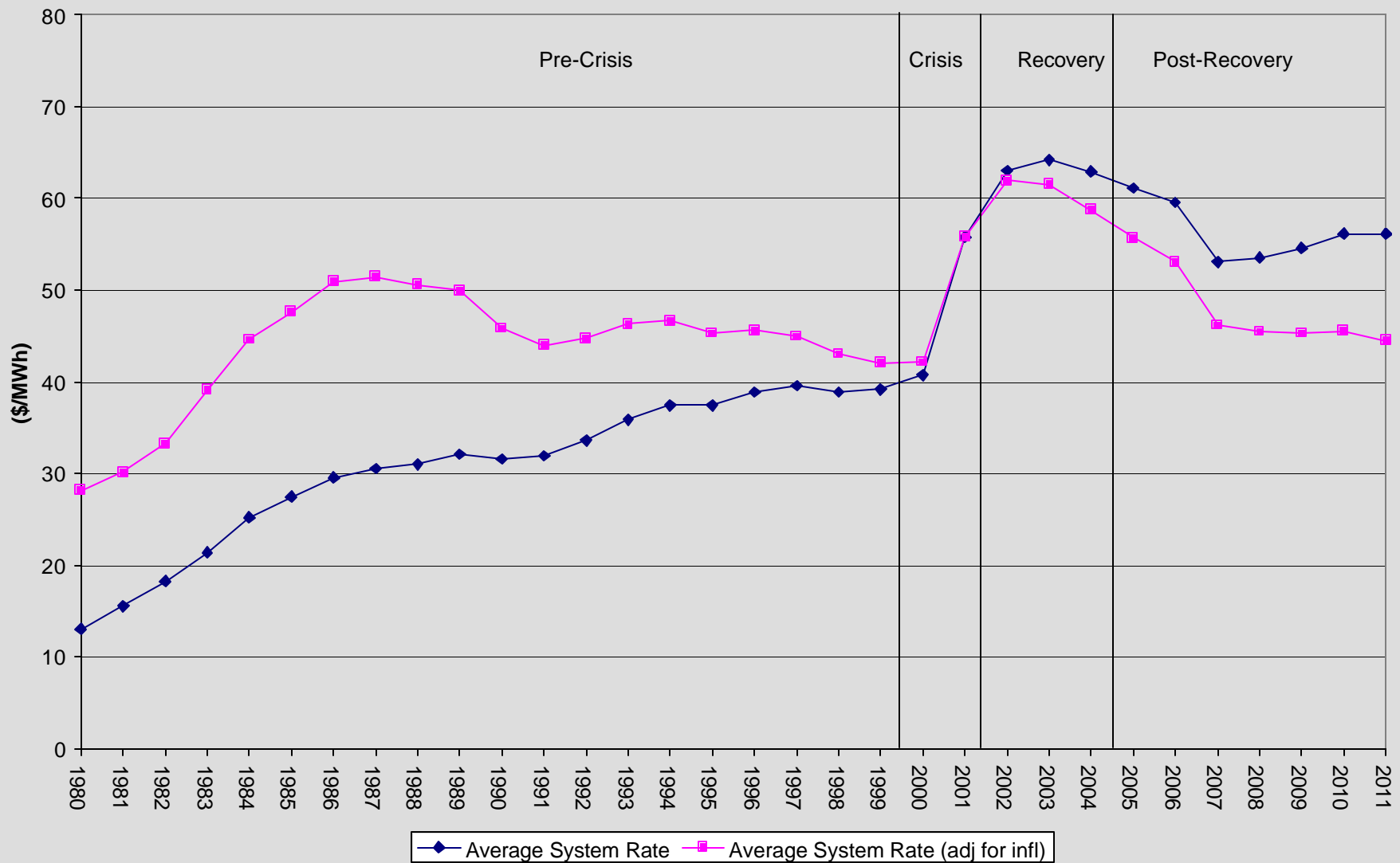
- Prior to 1989 there were 3 financial policies
 - Debt service coverage ratio of 2.0
 - 80% confidence of positive net income
 - 50% of general CIP should be financed from current revenue
- Rates were set high enough so that all three would be met
- In years leading up to 1989, debt service coverage was always the binding constraint

Concerns at End of 1980's

- Real rates increased 77% from 1980 - 1989
- Real debt increased 46% over the same period
- Capital costs were being paid relatively too much by the current generation of ratepayers
- Ratepayers would rather have more debt and lower rates given SCLs relatively low cost of capital

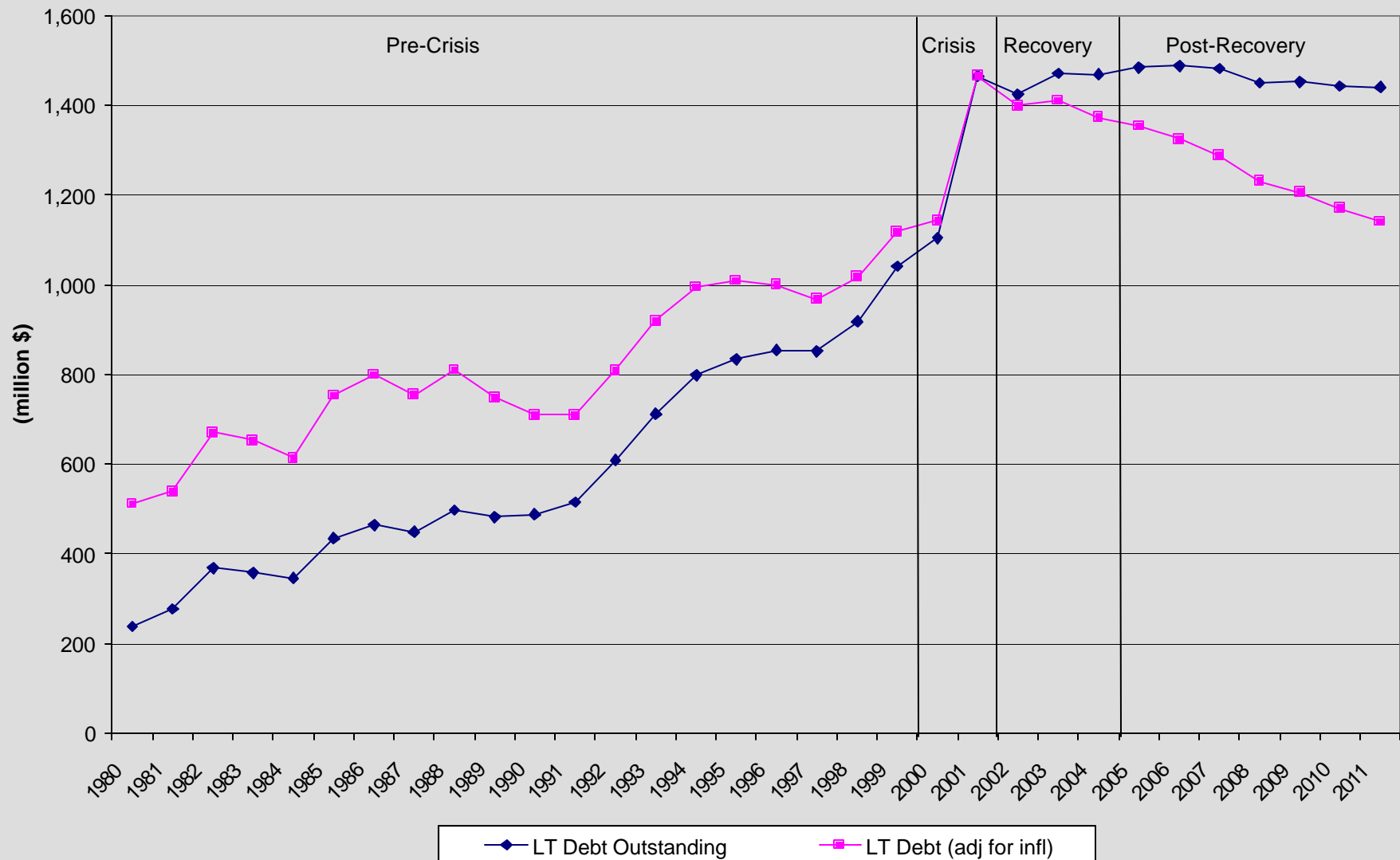


Average System Retail Rate



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Long Term Debt Outstanding



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1989 Financial Policy Change

- Single financial policy instead of three
- Change to 1.8 Debt Service Coverage ratio from 2.0
- Coverage of 1st lien debt only
- Plan for generally positive net income
- Report on other financial measures
- Purpose is to lower rates and raise debt

Result of Level of Capital Expenditure, New Financial Policy, and New Capitalization Policies

- Real rates decrease 8% from 1990 - 1999
- Real debt increases 58% over same period
 - as opposed to 46% over previous decade
- Enter energy crisis period with substantial debt

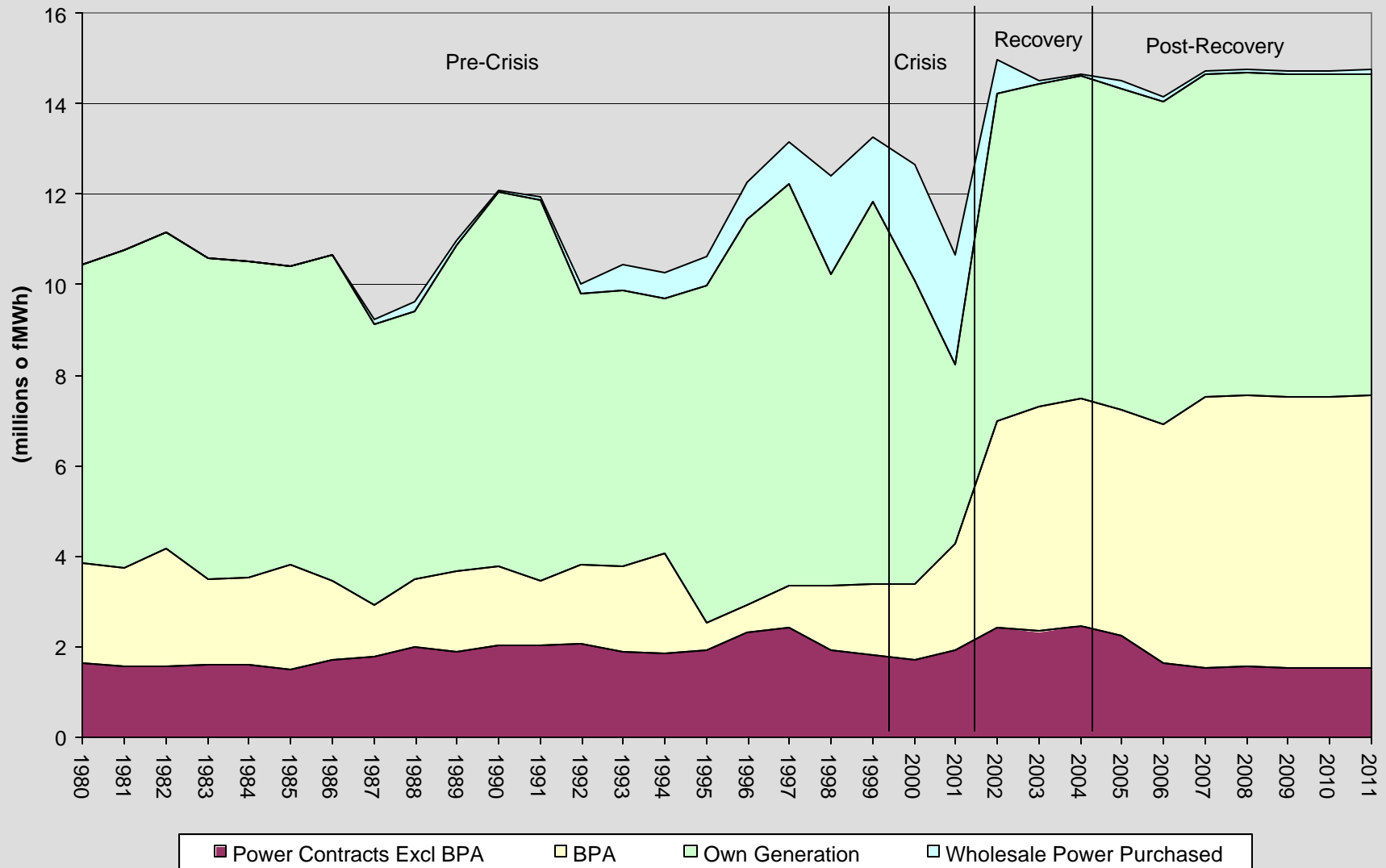
Analysis in 1999 Attributes 1990's Increase in Debt to:

- Level of Direct Capital Outlays 35 - 45 %
- Reduction in Debt Service Coverage Level 20 - 25 %
- Changes in Capitalization Policy 15 - 20 %
- Lower Interest Rates and Bond Refinancings 10 - 15 %
- Use of Variable Rate Debt (1990) 5 - 10 %

SCL Increases Reliance on Market

- Amendment of BPA contract in 1996
 - Computed requirements prior to 10/1/96
 - Limited to 195 aMW post-10/1/96
 - Saved money through 1998, when prices were low
- Sale of Centralia Plant in May 2000
 - Seattle owned 8% share
 - 103 MW of capacity, 81 aMW of energy
 - Did not purchase forward for year before Klamath came on line
- Result: Increased exposure to market risk

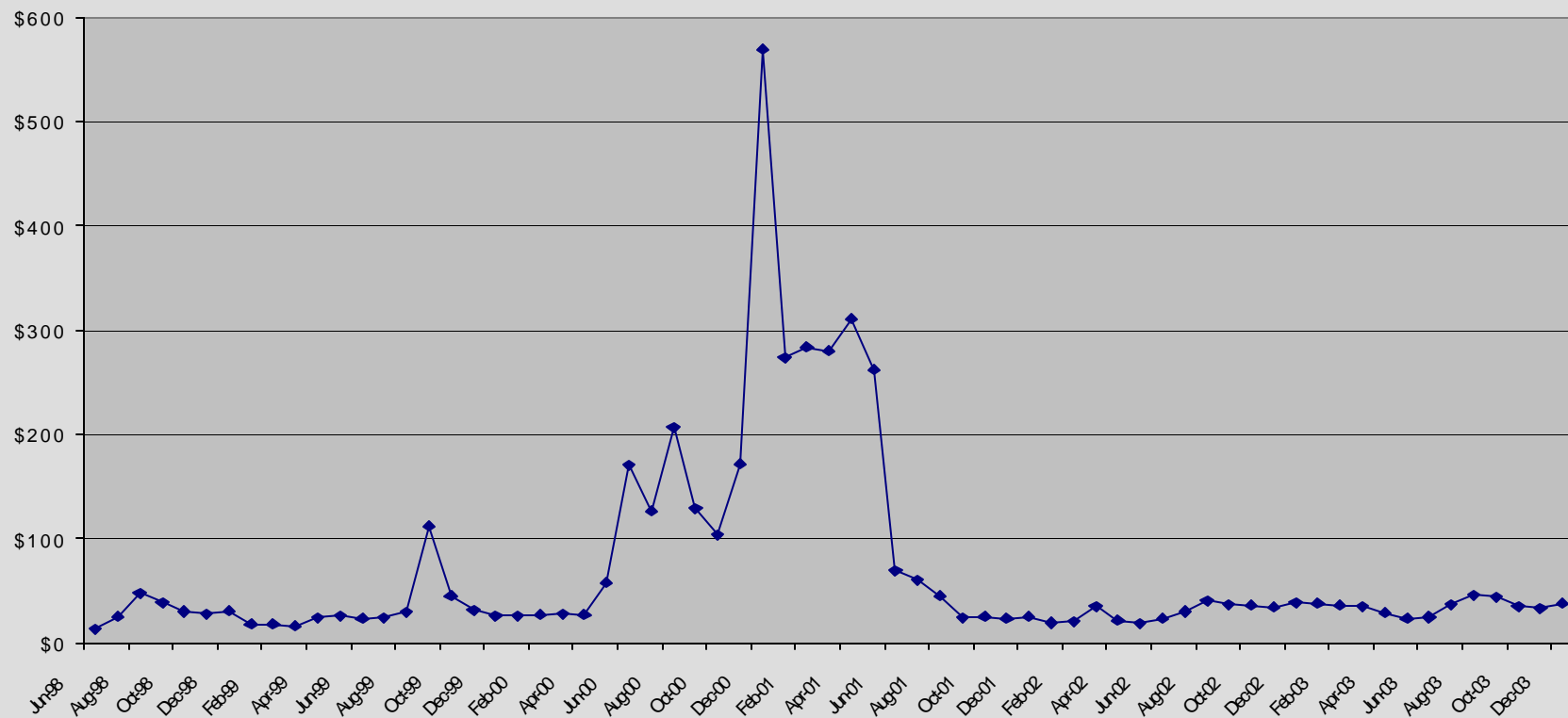
Resources



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Prices Reach 10 Times Historic Levels During Energy Crisis

Mid-Columbia Firm HLH Price
(Actual through 4/19/02, Forward from 4/20/02)



The “Perfect Storm”

- Wholesale prices rise sharply in May 2000 and again in November
 - stay high into June 2001
 - prices that were \$20-30/MWh rise to \$150-200 and then to \$300-500.
- Water conditions in the water year beginning October 1, 2000 were among the worst ever
 - SCL hydro output in 2001 was 55% of normal
- SCL’s 2001 net wholesale market purchases increased from a planned 24 aMW to 222 aMW.
 - Purchase roughly 10x the quantity at 10x the price.

SCL Response

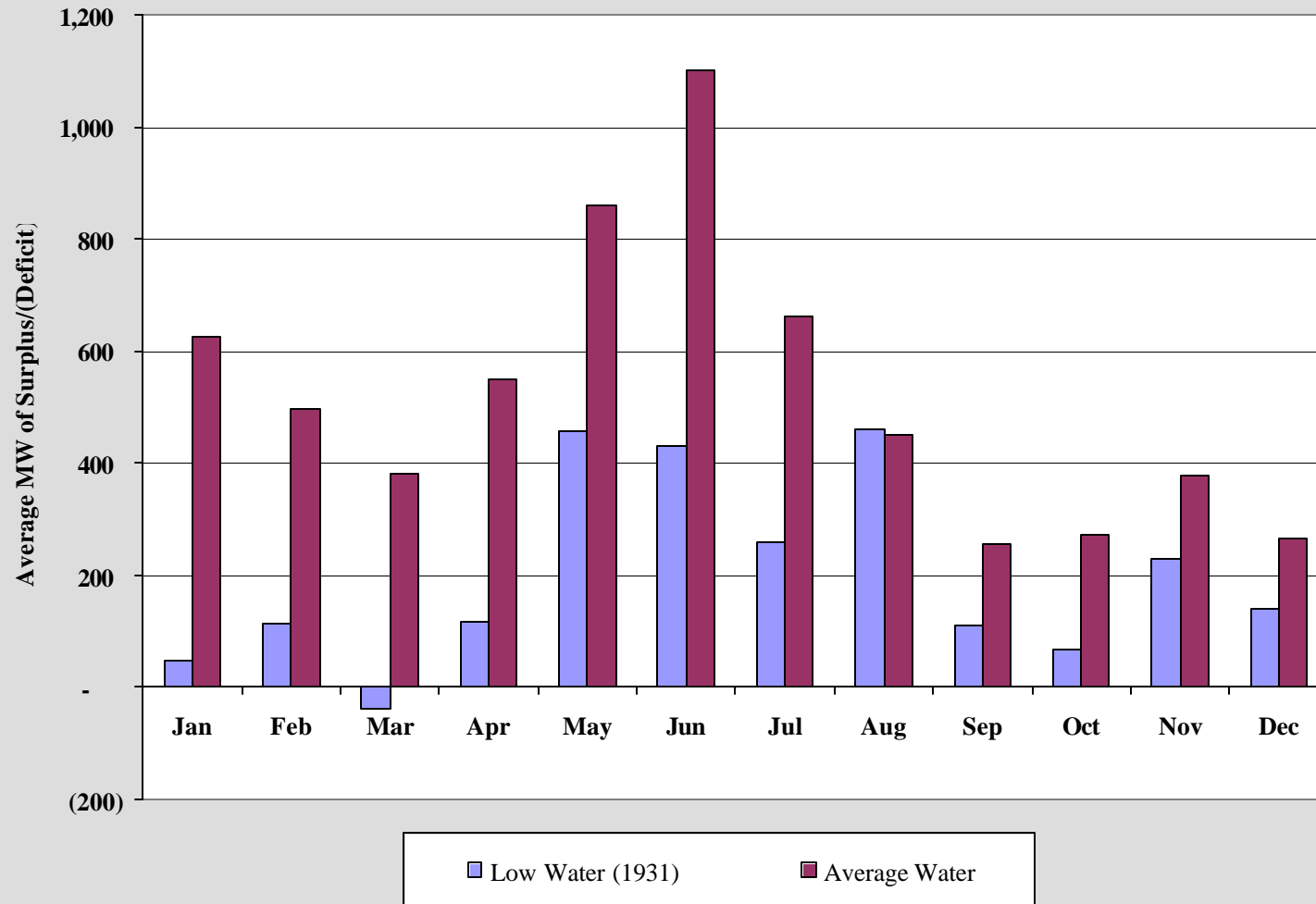
- Four rate increases in 2001
 - Aggregate increase: 57%
- Conservation and curtailment of energy use
 - 5% demand reduction from 2000 to 2001
- Automatic pass-through of BPA rate changes
- Use of short-term debt to cover operating needs
 - \$182 million RANs in 2001
 - \$125 million RANs in 2002
 - Loans from City Cash Pool
- Deferral of \$300 m of power costs on income statement

The Long-Term Solution

- Acquisition of resources to reduce dependence on wholesale market
 - Increase in BPA purchases from 195 aMW to over 550 aMW
 - 100 MW from Klamath Falls from 2001 through 2006 (renewable for another 5 years)
 - 50+ aMW from Stateline Wind Project
- New financial policies that recognize higher level of risk

Projected Monthly Surplus in 2004

Average and Low Water



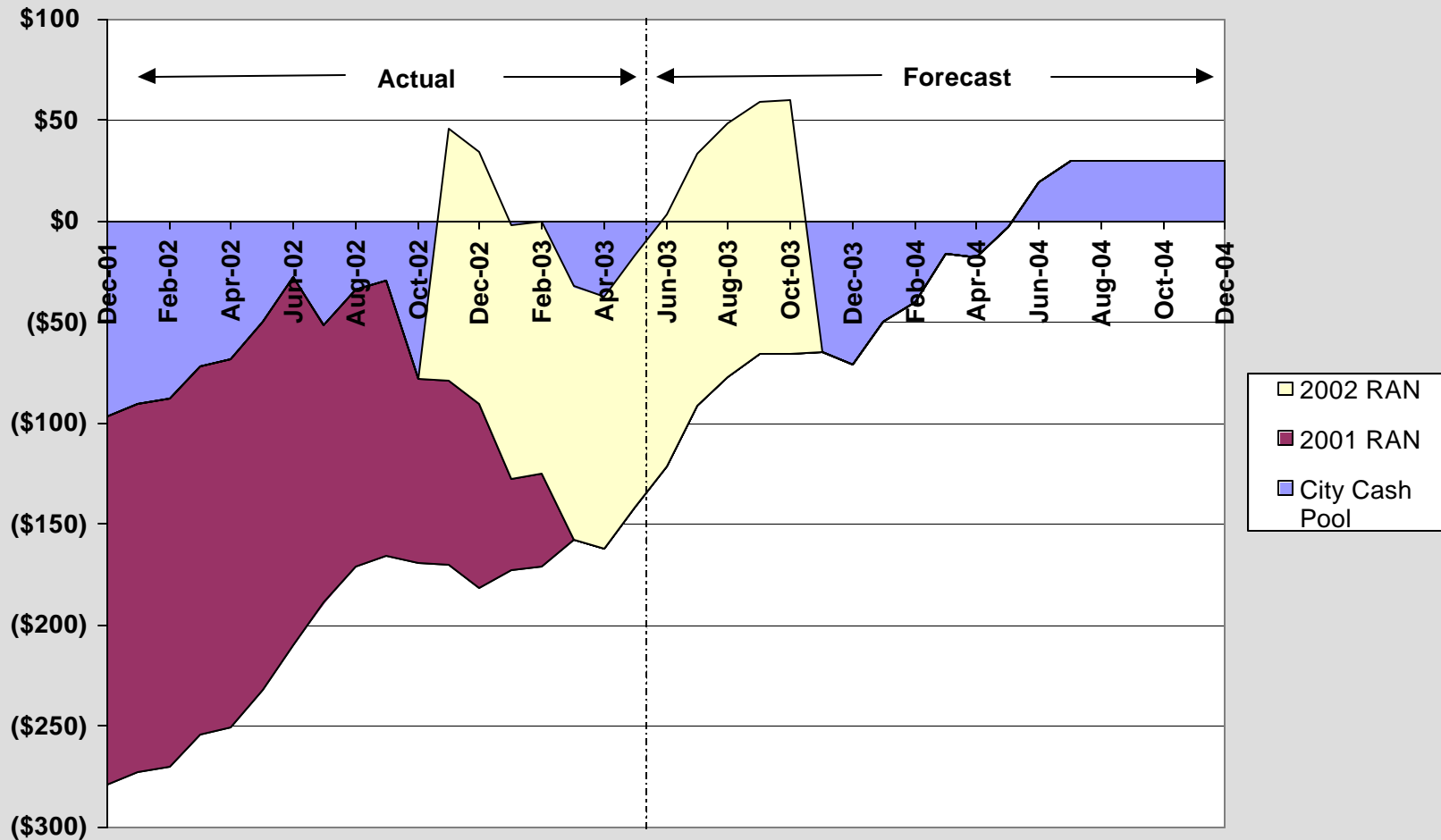
New Financial Policies

- Old policies required rates to be set to achieve 1.80 coverage of 1st lien debt service
 - Provided about 80 percent probability of covering operating costs and debt service, given pre-2001 volatility
- New policies require current rates to stay in place until all short-term debt is repaid (mid-2004) and operating cash balance reaches \$30 million
- When debt is repaid, rates will be set to achieve 95% probability of covering operating costs and debt service
 - Implies 1st lien debt service covered 2.1 times, all debt service covered 1.9 times
 - Implies about 50% cash financing of capital



Financing Operating Cash Needs: 2001-2004

(\$ in millions)



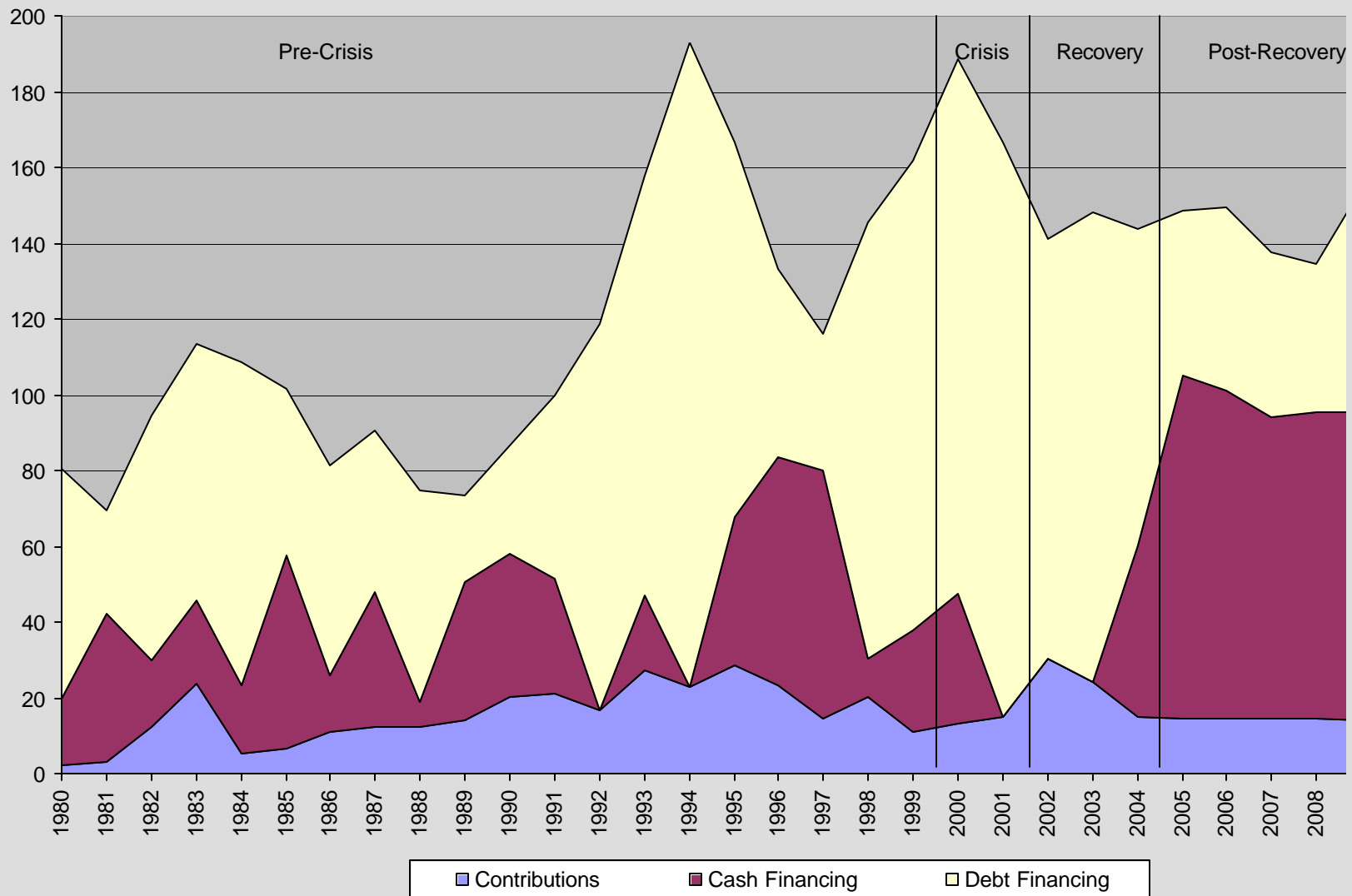
SCL in 2005 Under New Financial Policies

(\$ in millions)

	Average Water	Critical Water
Retail Revenue	\$558.7	\$558.7
Wholesale Revenue	135.4	48.6
Other Revenue	<u>42.1</u>	<u>42.1</u>
Total Revenue	\$736.1	\$649.4
Operating Expenses	\$478.0	\$478.0
Interest Income & Other Income	<u>13.7</u>	<u>13.7</u>
Net Revenue Available for Debt Service	\$271.8	\$185.1
Debt Service	134.0	134.0
Reserve Deposits (Bond & Contingency)	19.9	19.9
City Taxes & Other Cash Uses	31.2	31.2
Cash Available for Capital Financing	\$86.7	\$0.0

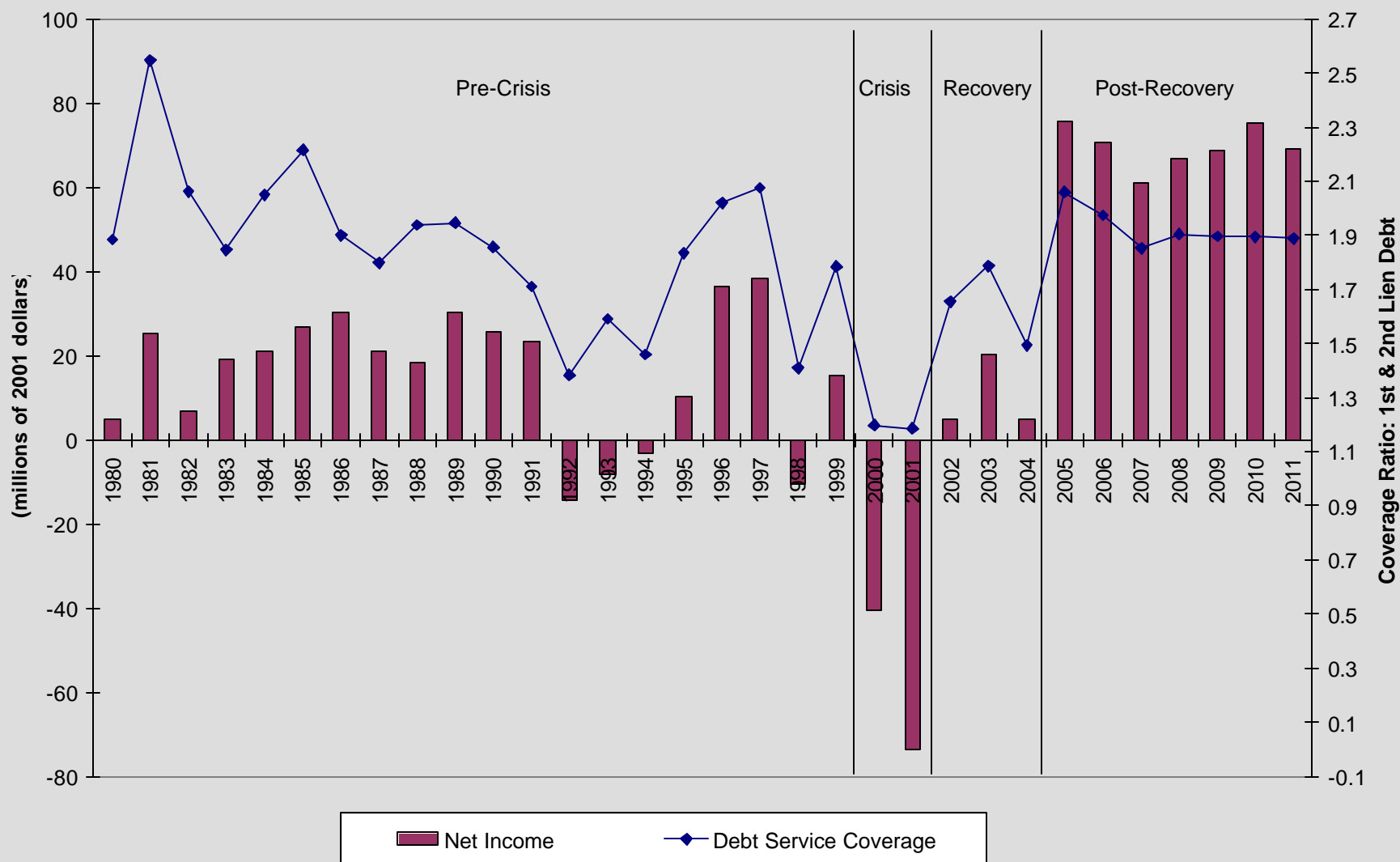


Sources of Capital Financing

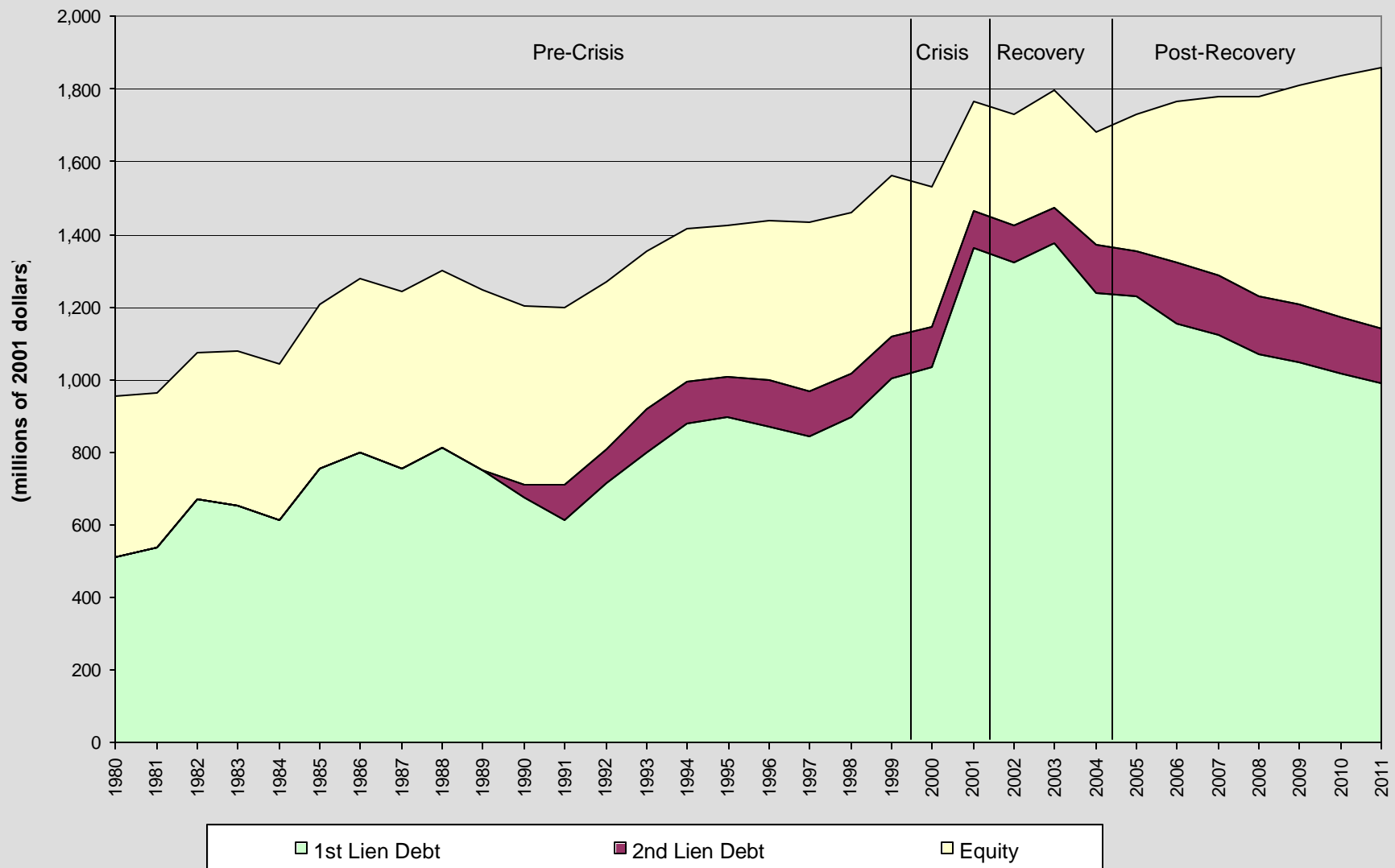


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Coverage and Net Income

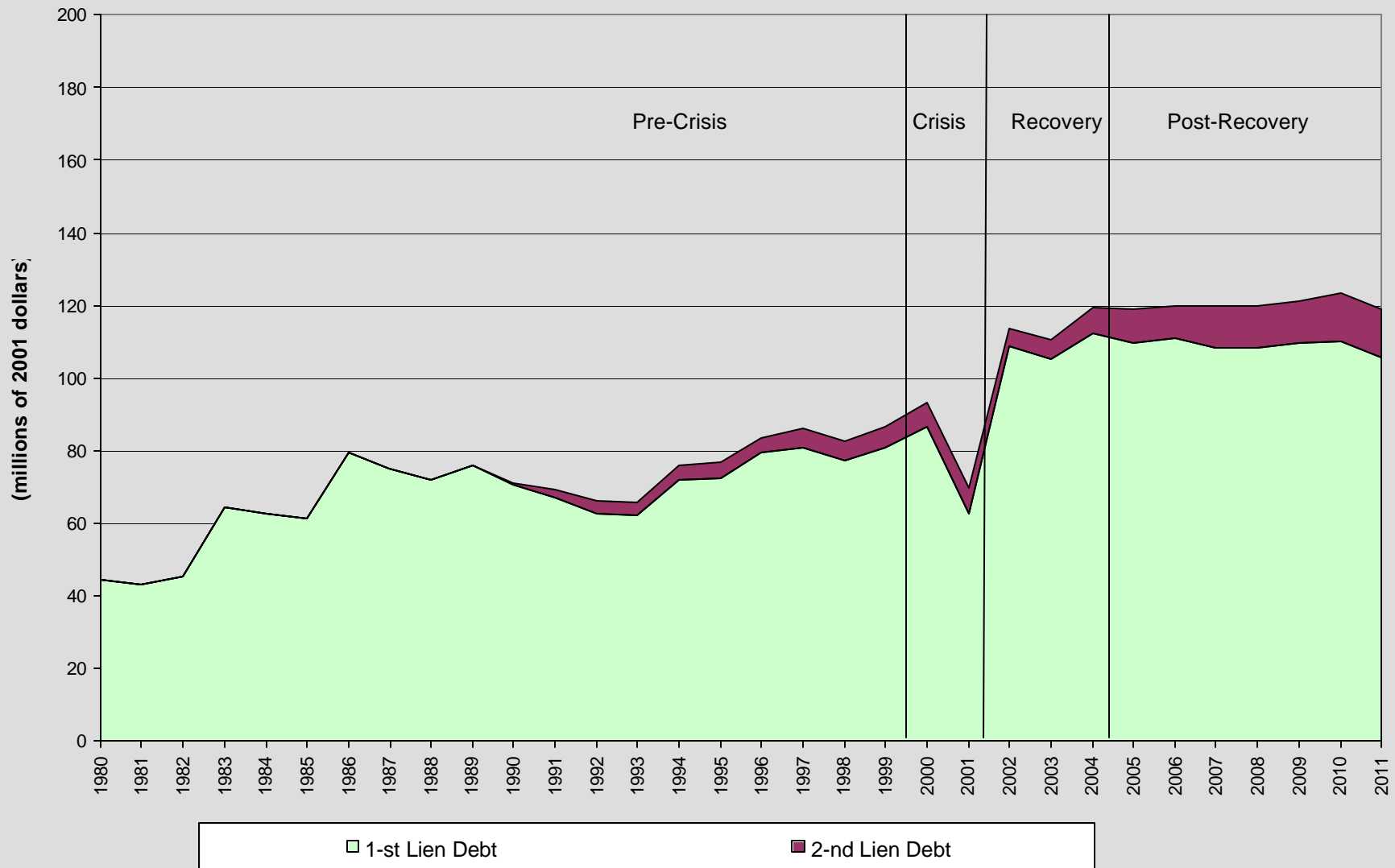


Debt and Equity



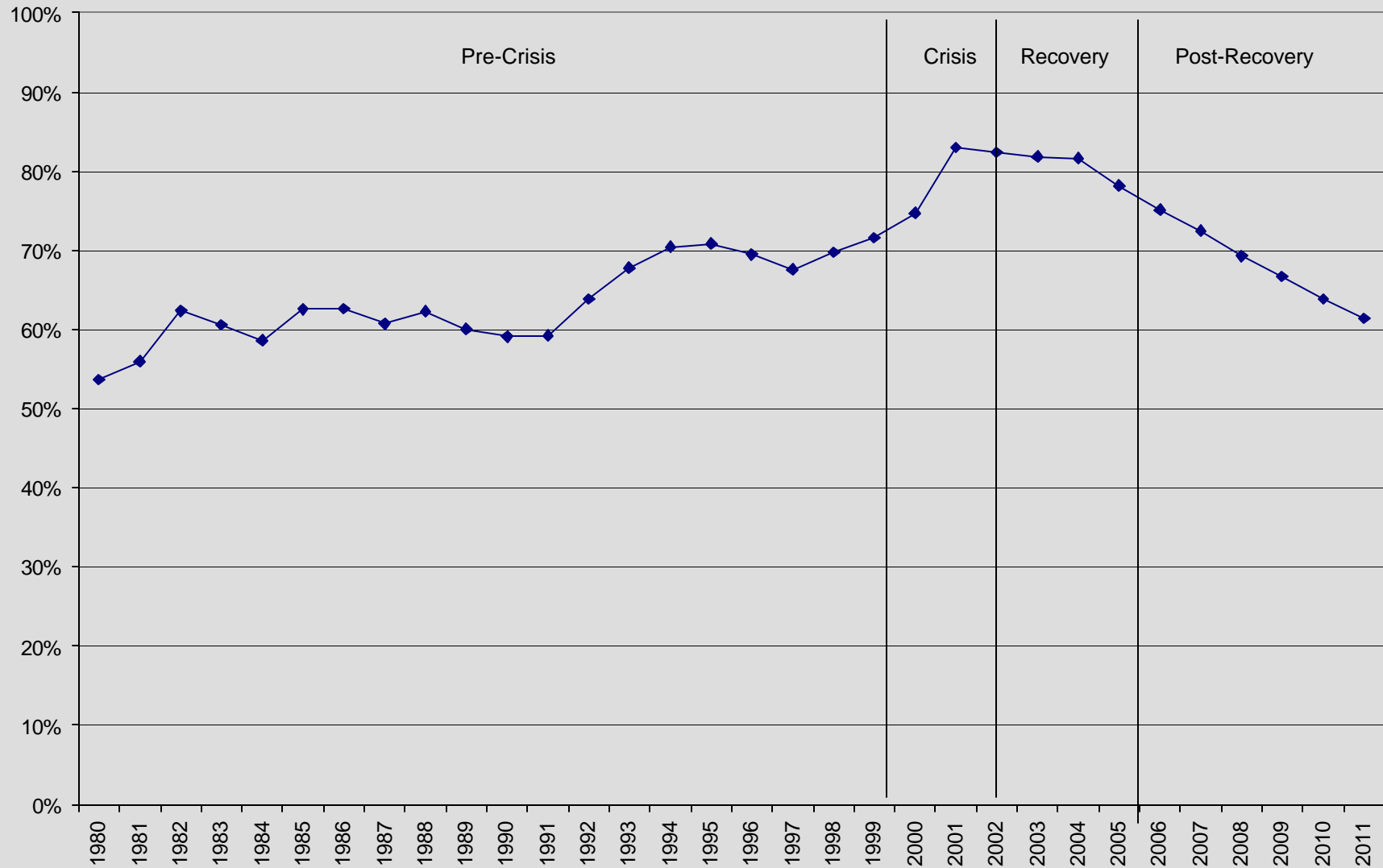
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Debt Service



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Long Term Debt as a Percent of Total Capitalization



Outstanding Financial Questions

- Details of New Financial Policies
 - is \$30 m operating cash balance a minimum, an average, a year-end target?
 - similar construction account target?
- Structure of Debt
 - variable vs fixed rate debt
 - fixed to variable swaps, renew letter of credit, auction program
 - principal or interest-only in first 5 years
 - bond reserve or surety bond

Rates Issues

- Capacity charge or equivalent?
- Power factor charge
- Suburban rate differential
- Continuation of BPA Passthrough?
- Levels of demand charge vs energy charge
- Network rates (none, half cost, full cost)
- Return to seasonal rates?
- Block structure (third block?)